

Factor Investing with ETFs

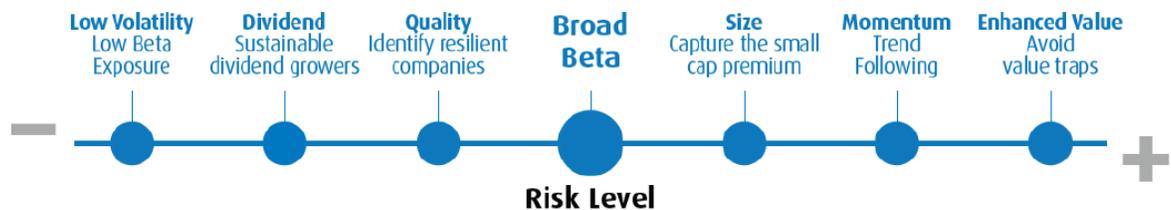
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Investing using factor tilts in a portfolio can be done either to manage risk or to generate alpha. Factor investing has been identified as one of the most significant advances in investment management in the last 20 years. Bridging the gap between Active management and Indexing, Factors incorporate the best of both worlds: low cost, consistent methodologies with the opportunity to outperform broad benchmark exposures.

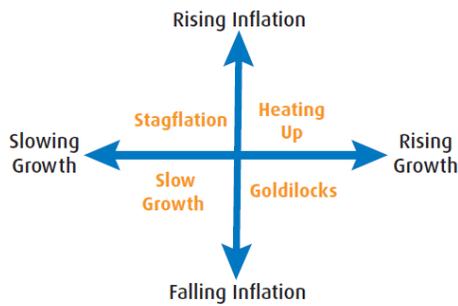
Factor ETFs are also sometimes referred to as “smart beta” ETFs. Using a broad *Beta* index is used as a starting point, screening rules are applied in order to achieve a desired outcome. There are six established factors that have been recognized and researched for decades:



When using factor-based ETFs, an investor must consider their risk tolerance, current position within the economic cycle, and current versus desired geographic and sector exposures. Risk tolerance must be considered because some factors tend to have higher volatility than others (low volatility tends to be the lowest risk over time, while value tends to be most volatile of all the established factors).

The economic cycle is of utmost importance as factors will perform differently based on inflation, interest rates and other macro variables. MSCI, one of the largest index providers in the world, has published a robust study that draws on over 40 years of data and shows the performance of equity factors at different points of the economic cycle (see table below):

Factor performance based on economic regimes



	Heating Up	Goldilocks	Slow Growth	Stagflation
World Equal Weighted Index	0.0%	0.4%	0.0%	-0.1%
World Dividend Index	-0.1%	0.0%	0.3%	0.2%
World Low Volatility Index*	-0.5%	-0.3%	0.4%	0.4%
World Quality Index	0.1%	-0.2%	0.3%	0.3%
World Enhanced Value†	0.3%	0.7%	0.1%	-0.2%

Source: MSCI Inc.

Average Monthly Gross Active Returns relative to MSCI World from Dec 1975 to May 2019.

Broad Market Proxy: MSCI ACWI Index (USD), Low Volatility Proxy: MSCI ACWI Minimum Volatility Index, (USD) Quality Proxy: MSCI ACWI Quality Index (USD), Dividend Proxy: MSCI ACWI High Dividend Yield Index (USD), Value Proxy: MSCI ACWI Enhanced Value Weighted Index (USD).

As COVID-19 first roiled markets in February and March of 2020, the quality factor did very well. Quality is defined as having High Return on Equity, Stable Earnings Growth and Low Leverage (Debt-to-Equity). Such resilient attributes are commonly found in sectors which did very well: technology, healthcare and consumer staples.

Currently, with rising inflation and rising growth as we see economies start to re-open and the population is vaccinated, the Value factor has enjoyed a resurgence (representing the “Heating Up” top right quadrant of the graph above).

MSCI also publishes their Adaptive Multi-Factor Allocation model, and as at the end of March, value and small cap were the two factors with the most favourable outlook:

Exposures from MSCI’s Adaptive Multi-Factor Allocation Model

	Macro Cycle	Valuation	Momentum	Market Sentiment	Composite
LOW VOLATILITY	--	+	--	--	--
YIELD	--	-	++	--	-
QUALITY	--	--	--	--	--
MOMENTUM	++	--	--	++	N
VALUE	++	++	++	++	++
LOW SIZE	++	++	++	++	++

As of Mar. 31, 2021. Positive exposures are denoted as + or ++, negative as - or --, neutral as N.

(Source: <https://www.msci.com/www/blog-posts/factors-in-focus-value-springs/02422569177>)

ZVU BMO MSCI USA Value Index ETF and ZVC BMO MSCI Canada Value Index ETF offer a pure exposure to the value factor. MSCI’s enhanced value methodology scores companies based on 3 equally weighted value metrics: price to book, price to (forward) earnings, and enterprise value to operating cash flows. The enhanced value indexes are designed to be sector neutral versus the benchmark.

Factor investing can also be looked at through a sector lens. In MSCI’s Multi Factor Model, recall that the small size factor also scores well given current conditions. The S&P400 (mid caps) and S&P600 (small caps) have drastically outperformed the broad market since the shift of the vaccine news in November.

While the MSCI Enhanced Value indexes provide sector neutral exposure and rank the companies according to best valuations within each sector, the S&P400 and 600 are cap-weighted indexes and result in sector exposure that is markedly different from the broad index. ZSML BMO S&P US Small Cap Index ETF (S&P600) and ZMID BMO S&P US Mid Cap Index ETF (S&P400) are even more levered to the re-opening trade as a by-product of more cyclical sector exposures. Versus ZVU and versus ZSP (BMO S&P 500 Index ETF), ZSML and ZMID have higher exposure to consumer discretionary, financials and industrials and materials stocks, and lower exposure to consumer staples, IT, and telecoms. Note that the risk level also increases when moving from ZVU to something like ZSML or ZMID.

GICS Equity Sector (%)												
	Portfolio Date	Consumer Discretionary	Consumer Staples	Energy	Financials	Healthcare	Industrials	Information Technology	Materials	Telecom Services	Real Estate	Utilities
BMO S&P 500 ETF (CAD)	2/28/2021	12.4	6.0	2.8	11.2	13.1	8.4	27.4	2.6	11.1	2.4	2.5
BMO MSCI USA Value ETF	2/28/2021	12.0	6.2	1.8	10.9	11.8	8.1	30.8	2.6	10.6	2.9	2.3
BMO S&P US Small Cap ETF	2/28/2021	15.3	3.8	3.9	17.2	11.8	18.0	14.0	4.8	2.1	7.6	1.5
BMO S&P US Mid Cap ETF	2/28/2021	15.8	3.5	1.2	15.6	11.2	18.6	14.0	5.9	1.9	8.9	3.2

(Source: Morningstar Direct, Feb 28 2021)

Using ETFs such as these, portfolio managers can overweight or underweight to certain factors or sectors tactically as market conditions change.

BMO is the largest provider of factor ETFs in Canada. (Bloomberg, Mar 31 2021)

Factor	Overview	ETF
Quality	BMO ETFs quality strategy selects companies with high quality scores based on 3 variables: high return on equity, stable earnings growth, and low financial leverage ratio.	<ul style="list-style-type: none"> BMO MSCI All Country World High Quality Index ETF (ZGQ) BMO MSCI Europe High Quality Hedged to CAD Index ETF (ZEQ) BMO MSCI USA High Quality Index ETF (ZUQ)
Value	BMO’s value ETFs provide a pure approach to the value factor using MSCI’s Enhanced Value methodology. The result is a refined strategy, identifying and avoiding potential value traps.	<ul style="list-style-type: none"> BMO MSCI Canada Value Index ETF (ZVC) BMO MSCI USA Value Index ETF (ZVU)
Low Volatility	BMO ETFs Low Volatility Strategy focuses on the risk of securities and analyzes the beta of a stock as the primary portfolio construction tool. BMO ETFs suite of Low Volatility ETFs provide investors with long-term solutions that provide downside protection.	<ul style="list-style-type: none"> BMO Low Volatility Canadian Equity ETF (ZLB) BMO Low Volatility US Equity ETF (ZLU, ZLU.U, ZLH) BMO Low Volatility International Equity ETF (ZLI, ZLD) BMO Low Volatility Emerging Markets Index ETF (ZLE)
Dividend	BMO ETFs dividend approach is a customized strategy that combines high yield with sustainable growth. Through an advanced 4 step screening process BMO ETFs analyzes each company’s willingness and ability to pay dividends over time with additional forward looking considerations.	<ul style="list-style-type: none"> BMO Canadian Dividend ETF (ZDV) BMO US Dividend ETF (ZDY, ZDY.U, ZUD) BMO International Dividend ETF (ZDI, ZDH)
Size	BMO ETFs applies an equal weight methodology to developed sectors which reduces security concentration often found in traditional sector based ETFs. Each security is allocated an equal weight rather than a market capitalization weight, which decreases security specific risk. Equal weighted ETFs eliminate a market capitalization bias bringing more focus on small capitalization and in turn, value companies. BMO ETFs Equal Weight Strategy is a more efficient way to implement a sector strategy and can complement or replace single stock holdings. BMO ETFs also offers US Small Cap and Mid Cap exposures for those looking to target a specific market capitalization exposure.	<ul style="list-style-type: none"> BMO Equal Weight Banks Index ETF (ZEB) BMO Equal Weight Oil & Gas Index ETF (ZEO) BMO Equal Weight Utilities Index ETF (ZUT) BMO Equal Weight REITs Index ETF (ZRE) BMO Equal Weight Canada Industrials Index ETF (ZIN) BMO Equal Weight US Health Care Hedged to CAD Index ETF (ZUH/ZHU) BMO Equal Weight US Banks Index ETF (ZBK) BMO Equal Weight US Banks Hedged to CAD Index ETF (ZUB) BMO Equal Weight Global Base Metals Hedged to CAD Index ETF (ZMT) BMO Equal Weight Global Gold Index ETF (ZGD) BMO S&P US Small Cap Index ETF (ZSML/ZSML.F/ZSML.U) BMO S&P US Mid Cap Index ETF (ZMID/ZMID.F/ZMID.U)

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